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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 98: INSURANCE CONTRACT LAW REFORM

The Business Insured's Duty of Disclosure and the Law of Warranties

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1 INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

1.1 The role of the Financial Markets Law Committee (the "FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 The English and Scottish Law Commissions (the "Law Commissions") began a joint review of insurance contract law in January 2006. In June 2012, the Law Commissions published a third and final consultation paper in their joint review of insurance contract law: "Insurance Contract Law: the Business Insured's Duty of Disclosure and the Law of Warranties" (the "Consultation Paper"). The body of this paper addresses areas of legal uncertainty arising from the proposals in the Consultation Paper. Reflecting the approach adopted by the Law Commissions, these legal uncertainties fall into two categories: (i) issues relating to the reform of the duty of the disclosure of business insureds, and (ii) issues arising from the reform of the law of insurance warranties. Extracts from the Marine Insurance Act 1906 (the "1906 Act") are set out, for reference purposes, in the Appendix.

Executive summary

1.3 This paper examines legal uncertainties arising from the reform of the business insured's duty of disclosure. First, it reviews proposals to reform the standard for "fair presentation of risk" and asks whether the Law Commissions consider that the test for materiality in section 18(2) of the 1906 Act should be retained. It also raises certain issues concerning the Law Commissions' proposals to establish guidance and protocols to develop market understanding of this standard. Second, the paper requests clarification of the extent to which the Law Commissions consider that market participants should be permitted to contract out of the new codified disclosure regime.

1.4 The paper raises three issues in response to the Consultation Paper's proposals for reforming the law of warranties. It:

a. highlights certain ambiguities, which could arise from the proposal that, in the case of terms intended to reduce the risk of a particular type of loss, warranties should be suspended only in respect of that type of loss; and

b. recommends that the Law Commissions consider whether it would be effective to codify in law the requirement that terms may only be treated as warranties where they are expressly described as such.

2 BUSINESS INSURED'S DUTY OF DISCLOSURE

Fair presentation of the risk

2.1 The Consultation Paper states that the Law Commissions consider that the duty of non-disclosure set out in section 18 of the 1906 Act "appears unduly wide" and that the Law Commissions' "starting point is that the policyholder should make a fair presentation of the risk".[1] This is presented as a codification of existing case law. The Consultation Paper states that the starting point is

> already found within the current case law, but we think they need to be more widely known. We propose to include them within the statute. [2]

2.2 The Law Commissions propose that essential elements of section 18(1) of the 1906 Act be retained, in particular that

> the duty to disclose arises before the contract is concluded; that the policyholder must disclose material circumstances; and that the duty is confined to information which the policyholder knows or ought to know.[3]

In contrast, no direct reference is made in the Law Commissions' proposals for reform as to whether the test for materiality set out in section 18(2) should be retained (that is, the provision that "every circumstance is material which would

[1] Paragraphs 1.3-14 of the Consultation Paper. Section 18 of the 1906 Act is set out in full in the Appendix.

[2] Paragraph 1.27 of the Consultation Paper.

[3] Paragraph 5.71 of the Consultation Paper.

influence the judgement of a prudent insurer in fixing the premium, or determining whether he will take the risk"). The Consultation Paper notes that the formulation of the test for what is material can be criticised both for placing a heavy burden on the policyholder (who may have little understanding of how insurers price risks), and for allowing the insurer to play "a purely passive role" (that is, to not ask questions of the policy holder).[4] The Consultation Paper also outlines a non-exhaustive list of standards for what amounts to a "material circumstance which is required to provide a fair presentation of the risk" under caselaw, namely

a. any unusual or special circumstances which increase the risk;

b. any particular concerns about the risk which led to the insurance being placed; and

c. standard information which market participants generally understand should be disclosed.[5]

2.3 It is unclear whether the Law Commissions have concluded, on this basis, that the test in section 18(2) should not be retained in any codification of the duty of disclosure, and that what is "material" should now be defined solely by reference to what is a "fair presentation of the risk". The FMLC therefore requests that the Law Commissions clarify whether they consider that the test for materiality in section 18(2) should be retained or removed.

2.4 The Law Commissions suggest that the test for fair presentation of risk should be based on an established market understanding, and outlines how such an understanding could be developed:

> it would be helpful for insurers and policyholders to work together to develop guidance and protocols over what a standard presentation of the risk should include. Different protocols could cover different types of insurance. Different protocols could even cover the same type of insurance, with policyholders declaring which protocol they

[4] Paragraph 5.5 of the Consultation Paper.

[5] Paragraph 5.72 of the Consultation Paper.

had followed in presenting the risk.[6]

The proposal that insurers and policyholders will work together in this way should take into account to certain difficulties (below).

a. It requires will, time and commitment on both sides.

b. It is unclear as to how the pool of participants from the insureds would be identified and engaged.

c. It is to be expected that the production of such guidance and protocols might fragment practice across the insurance industry.

d. It is as yet unclear how compliance with the guidance and protocols might be secured. If they are not mandatory, it is unclear what incentive there will be for participants in the market and for businesses to use them.

2.5 The test for fair presentation of risk could therefore become more uncertain if it was to be determined primarily by reference to this type of (as yet undeveloped) market understanding. The FMLC would welcome the Law Commissions' view as to how the process for producing this type of guidance and protocols should operate (in particular, how contributors should be selected and co-ordinated) and whether such guidance should have mandatory effect.

Contracting out

2.6 The Law Commissions have concluded that

> proportionate remedies should be the default remedy for non-disclosures and misrepresentations which are not dishonest. It should, however, be open to the parties to contract out of proportionate remedies if they wish.[7]

[6] Paragraph 5.74 of the Consultation Paper.

[7] Paragraph 9.4 of the Consultation Paper; Paragraph 1.19 of the questionnaire on the Business Insured's Duty of Disclosure. asked consultees whether they agree that "the parties to a business insurance contract should be entitled to contract out of the proportionate remedies for non-disclosure and misrepresentation in favour of the insurer through a contract term."

The Consultation Paper does not address whether parties would be able to agree that such a contracting out provision can extend beyond the default application of proportionate remedies. This could create legal uncertainty as to the extent to which parties will have the right to contract out other elements of the proposed reforms. The FMLC therefore requests that the Law Commissions clarify whether they consider that parties should be able to define, in their contract, expected standards for disclosure that differ from those included in the new law.

2.7 The Law Commissions note that one of the reasons for introducing this approach (that is, introducing proportionate remedies as a default regime and allowing parties to contract out of these remedies) is that proportionate remedies may not be suited to specialist areas.[8] It is unclear from the Consultation Paper whether the Law Commissions have considered if the newly codified standards of disclosure are suited to specialist lines of insurance business. As the Law Commissions will have taken into account, there are limited resources available for implementing reforms by way of primary legislation. It is therefore possible that, when allocating parliamentary time for implementing these reforms, a distinction may be drawn between the value of implementing reforms that are mandatory, and those from which parties can contract out. The FMLC would therefore welcome an indication from the Law Commissions as to whether:

a. priority should be given to legislating for mandatory measures when the reforms are implemented; and

b. the Law Commissions have considered whether parties should be allowed to contract out of the codified disclosure regime by imposing contractual standards for disclosure.

[8] Paragraph 9.34 of the Consultation Paper.

3 THE LAW OF WARRANTIES

Terms to reduce particular risks

3.1 The Law Commission's third proposal in respect of warranties proposes

> *To introduce special rules for terms designed to reduce the risk of a particular type of loss, or the risk of loss at a particular time or in a particular location*. For these terms, a breach would suspend liability in respect only of that type of loss (or a loss at that time or in that place). Thus the breach of a warranty to install a burglar alarm would suspend liability for loss caused by an intruder but not for flood loss. Similarly, a failure to employ a night watchman would suspend the insurer's liability for losses at night but not for losses during the day.[9]

3.2 As noted in the Consultation Paper, this proposal (i) would not apply to those warranties which are not aimed at reducing the risk of loss, and (ii) would apply to terms designed to reduce the risk of loss which are not "true warranties" within the definition set out in section 33.[10] This invites debate as to the distinction between warranties (and other terms) which are, and those that are not, designed to reduce the risk of loss. Debate of this kind could add complexity to disputes between insurers and insureds. The FMLC would therefore welcome clarification from the Law Commissions as to how broadly the category of "risk" is drawn, in this context, and what it means to "reduce" such risk.

3.3 Broadly speaking, there are two possible ways in which a warranty could be intended to "reduce the risk" of loss:

a. the insured could warrant that it does, and will continue to, engage in (or refrain from) behaviour which is correlated to a lower (or higher) risk of loss; and

b. the insured could warrant that certain conditions are met, which may have the

[9] Paragraph 11.22 of the Consultation Paper. This proposal is set out in further detail at paragraphs15.35-53 of the Consultation Paper.

[10] Paragraph 15.38 of the Consultation Paper.

indirect effect of incentivising behaviour which lowers the level of risk.

3.4 In the first case (paragraph a), uncertainty could arise as to the extent to which the insurer would be required to show correlation between the type of behaviour promoted by the warranty and the risk of loss arising. That is, would it be necessary to show that such behaviour corresponds directly to the level of risk, or would it be sufficient to show a weaker, indirect correlation between certain actions and the level of risk? The Law Commissions note that "there may be borderline cases that turn on their particular facts" and that the real issue "is what the term was designed to do in relation to the risk".[11] The FMLC would welcome the Law Commissions' view on whether its third proposal should therefore apply to any warranties which are intended to reduce the risk of loss through promoting risk-avoidant behaviour (or prohibiting risky behaviour)—even in cases where the correlation between such behaviour and the risk of loss is weak and/or indirect.

3.5 The Consultation Paper states that warranties which address "moral hazard" (for instance, those relating to a policyholder's criminal record) will not be affected by this proposal.[12] On this basis, the FMLC concludes that the Law Commissions do not consider that "condition" warranties (as described in paragraph b, above), should be treated as reducing risk for these purposes.

3.6 The Law Commissions state that in the Consultation Paper that they "do not propose to introduce a causal connection test".[13] However, market participants would benefit from greater clarity as to the extent to which the insurer must show a causal connection between the behaviour targeted by the warranty and the loss which has occurred. That is, should the insured be able to recover for loss, provided that such loss was not a crystallisation of the risk which the insured warranted that it would, but did not in fact, reduce? For example, one may consider a warranty that a building has good door locks. Is the relevant "risk" a peril resulting from unauthorised access to the building? Or is it confined to a peril resulting from unauthorised access to the building where entry is gained via the relevant doors? If the wider category, this could give rise to the kind of absurdity highlighted by the

[11] Paragraph 15.50 of the Consultation Paper.

[12] Paragraph 15.38 of the Consultation Paper.

[13] Paragraph 15.48 of the Consultation Paper.

Law Commissions, and which their proposals for reforms aim to remove. For example if there were no adequate door locks but a burglar broke in via a window—thereby proving that the lack of a door lock did not contribute to the loss. If the "type" of loss was harm resulting from unauthorised access generally, the cover would be suspended even though the breach of warranty was irrelevant to the risk. The precise breadth of the category of risk is a further potential source of dispute, which would not arise, for example, under a "causation" based approach to warranties. The FMLC would welcome the Law Commissions' view on how parties should identify the category of "risk" in borderline cases and, in particular, the extent to which the type of risk addressed by a particular term must correspond to the type of loss suffered in order for liability relating to that loss to be suspended. It is noted that the closer the link is made between the suspension and the actual loss suffered, the closer the proposal comes to a "causation" approach which has been rejected separately by the Law Commissions.[14]

Definition of warranty

3.7 The Consultation Paper notes that "the term "warranty" has caused considerable confusion".[15] Policies for business insurance will often include a statement that no term is to be construed as a warranty unless expressly described as such. This helps to mitigate at least some of the uncertainty regarding whether any particular term should be construed as a warranty. Given the continued key status of warranties (and the particular remedies suggested to apply to them), the FMLC recommends that the Law Commissions consider the efficacy of codifying this position at law.

4 CONCLUSION

4.1 The FMLC considers that reform of the business insured's duty of disclosure and the law of warranties would be more effective if the legal uncertainties highlighted in this paper are addressed. Accordingly, it would welcome the Law Commissions' views, in their final report, on:

a. whether the test for materiality in section 18(2) of the 1906 Act should be

[14] Paragraph 15.48 of the Consultation Paper.

[15] Paragraph 12.3 of the Consultation Paper.

retained;

b. how the process for preparing guidance and protocols concerning the fair presentation of risk should operate;

c. the extent to which market participants should be permitted to contract out of the new codified disclosure regime;

d. how market participants should distinguish between warranties which are, and those which are not, designed to reduce particular risks of loss; and

e. whether it would be appropriate to codify in law that terms should only be treated as warranties where they are expressly described as such.

APPENDIX

1 SECTION 18 OF THE 1906 ACT (DISCLOSURE BY ASSURED)

(1) Subject to the provisions of this section, the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him. If the assured fails to make such disclosure, the insurer may avoid the contract.

(2) Every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.

(3) In the absence of inquiry the following circumstances need not be disclosed, namely:—

(a) Any circumstance which diminishes the risk;

(b) Any circumstance which is known or presumed to be known to the insurer. The insurer is presumed to know matters of common notoriety or knowledge, and matters which an insurer in the ordinary course of his business, as such, ought to know;

(c) Any circumstance as to which information is waived by the insurer;

(d) Any circumstance which it is superfluous to disclose by reason of any express or implied warranty.

(4) Whether any particular circumstance, which is not disclosed, be material or not is, in each case, a question of fact.

(5) The term "circumstance" includes any communication made to, or information received by, the assured.

(6) This section does not apply in relation to a contract of marine insurance if it is a consumer insurance contract within the meaning of the Consumer Insurance (Disclosure and Representations) Act 2012.

2 SECTION 33 OF THE 1906 ACT (NATURE OF WARRANTY)

(1) A warranty, in the following sections relating to warranties, means a promissory warranty, that is to say, a warranty by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts.

(2) A warranty may be express or implied.

(3) A warranty, as above defined, is a condition which must be exactly complied with, whether it be material to the risk or not. If it be not so complied with, then, subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date.

3 SECTION 34 OF THE 1906 ACT (WHEN BREACH OF WARRANTY EXCUSED)

(1) Non-compliance with a warranty is excused when, by reason of a change of circumstances, the warranty ceases to be applicable to the circumstances of the contract, or when compliance with the warranty is rendered unlawful by any subsequent law.

(2) Where a warranty is broken, the assured cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss.

(3) A breach of warranty may be waived by the insurer.

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